No. 22496 ✓

In The

UNITED STATES COURT OF APPEALS

For The Ninth Circuit

AUG 19 1968

GYRO ENGINEERING CORPORATION

Appellant,

vs.

UNITED STATES OF AMERICA

Appellee,

REPLY BRIEF FOR THE APPELANT

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FILED

AUG 14 1968

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DISAGREEMENT WITH APPELLEE'S STATEMENT OF THE OPINION BELOW

In its opening brief Gyro stated, under the designation "Opinion", that:

> "The District Court wrote no opinion. Rather it signed and entered the Findings of Fact and Conclusions of Law submitted by the government. (706-753)."

Nevertheless, the government's reply brief claims, under the designation "Opinion" that:

> "The opinion of the District Court (II-R. 706-750) is officially reported at 276 F. Supp. 454 (C.D. Calif. 1967)."

However, a reading of 276 F. Supp. 454 shows, on its face, that

the District Court did not write an opinion, but merely signed and entered the Findings of Fact and Conclusions of Law submitted to it by the government. (Compare II-R. 706-750 with 276 F. Supp. 454).

AGREEMENT WITH APPELLEE'S STATEMENT OF JURISDICTION

Gyro agrees with the government's statement of jurisdiction.

DISAGREEMENT WITH APPELLEE'S STATEMENT OF QUESTION PRESENTED

The government's statement of the Question Presented ignores virtually all of the 53 Specifications of Error Relied On, and would, if accepted as a proper statement thereof, result in Gyro being deprived of rulings on the errors assigned by it. The issue on appeal here is not whether "the record warrants the District Court's conclusion" that there was no bona fide sale, but whether certain fundamental findings of fact upon which the conclusions of law are based were clearly erroneous, whether certain findings of fact prerequisite to the conclusions of law were even made, and whether the conclusions of law which were made misinterpret and misapply the law. The government's effort to avoid those questions and the 53 specifications of error related to them by its trial de novo brief directed to the generalization of whether the record warrants the conclusion of no bona fide sale begs virtually every issue raised on appeal, and raises the serious question of why the government was unable to respond to

those questions.

DISAGREEMENT WITH APPELLEE'S STATEMENT OF THE STATUTES INVOLVED

In addition to the statutes set forth by appellee, Section 1239 should be added for the reasons set forth in Part I of Gyro's opening brief.

DISAGREEMENT WITH APPELLEE'S STATEMENT OF THE CASE

The government's statement of the case, conceded by it in the first sentence thereof to be a summary, is subject to serious criticism because it avoids those facts stipulated by the parties and adduced at the trial which are unfavorable to its view of the case, because many of its statements of fact are actually contradicted by the stipulations of fact and the other evidence, because many of the record citations in "support" of its "fact" statements are the very findings of fact which Gyro has previously shown are clearly erroneous and to which the government has declined to respond, and because many of its statements support only the conclusion that Gyro was in reality the Mowrys whereas the critical conclusion of law was that Gyro owed the deficiencies in tax and hence did exist for tax purposes.

As an example of the former (omissions of fact), there is the <u>failure</u> of the government to set forth the several <u>activities</u> of Gyro from April 1953 to 1959 other than its gyroscop activities, followed by its statement that Gyro was moribund, which then served as the "support" for the conclusion that the

January I, 1959 purchase revived the corporation.

Illustrative of the statements supporting a conclusion that there was no corporation for tax purposes but only Chris and Natalie Mowry whereas the key conclusion herein was that Gyro owed the disputed deficiencies rather than any other taxpayer are those statements claiming that Gyro had no telephone, that the only bank account was that of Chris and Natalie Mowry, that Gyro filed no federal withholding tax returns, that payroll checks were issued in the name of Chris and Natalie Mowry, that no books were offered in evidence, that Chris and Natalie Mowry retained control over the real property sold, and that Chris Mowry dealt with the assets as he did with his own assets and business, "and paid little heed to the amenities of doing business through the corporation form." (See pages 4-6 of Appellee's Brief).

With respect to those statements by the government which are contradicted by the stipulations and other evidence, the following are examples thereof:

(I) "All money 'paid in' for the stock issued by the taxpayer and representing the paid-in 'capital' of taxpayer from the time of its incorporation throughout the years in suit was simply money deposited in the personal bank account of Chris and Natalie Mowry." (Appellee's Brief at 4). Yet Stipulation of Fact No I states that "Chris and Natalie Mowry paid $2,500 for the shares issued April 20, I953," and "Twenty-five hundred dollars was also paid for the shares transferred from Chris Mowry to William Mowry on April 20, I953." (R. I-48 at lines I5 through I9). Since the 5,000 shares could hardly be "paid" for if the

money was simply paid to Chris and Natalie Mowry, the above statement of fact by appellee is contradicted by the stipulation of facts it signed.

(2) "Any actual cash representing the paid-in 'capital' of taxpayer was supplied by Chris and Natalie Mowry." (Appellee's Brief at 4). However, Stipulation of Facts No I states that "William Mowry actually supplied the consideration for 25% of the stock interest in Gyro in that manner." (R. I-49 at lines 9 through I2). Thus, the government's statement of "fact" is either directly contradicted by the stipulation of facts it signed or is so misleading as to be a contradiction thereof.

(3) "With the exception of this purchase (the Paloma Street property), taxpayer was, <u>on the whole</u>, inactive between I953 and I959." (Appellee's Brief at 5). But the uncontradicted testimony of Chris Mowry is that during that period a number of different real estate developments were investigated, scientific research on long range weather forecasting and how the eye sees color and on the unified field theory was done, and patent applications were filed. (Tr. II-239-240).

(4) "There is no evidence that the taxpayer kept any books." (Appellee's Brief at 5). However, the President of Gyro testified, without later impeachment, as follows:

"Q. Does Gyro Engineering maintain its own books and records?

A. Yes.

Q. For how long?

* * *

A. Well, from the beginning, from 1952." (Tr. II-241).

Obviously it is false to say "there is no evidence that the taxpayer kept any books."

(5) "Taxpayer entered into what purported to be a written 'sales and purchase agreement' with Chris and Natalie Mowry by which it purported to buy from them three parcels of improved real property consisting of apartment buildings and the land on which they are situated known as The Tropics, The Carousel, and The Orange Grove Circle Apartments." (Appellee's Brief at 5). Yet in Stipulation of Facts No I, the government stipulated that:

> "Gyro Engineering Corporation <u>purchased</u> from Chris and Natalie Mowry three (3) parcels of improved real property known and referred to respectively as (1) "The Tropics", (2) "The Carousel", and (3) "The Orange Grove Circle Apartments"." (R. I-50).

Thus, the stipulation contradicts the government's above statement of "fact".

(6) "The total 'sale price' was purported to be $3,164,000." (Appellee's Brief at 6). But Stipulation of Facts No I states that:

> "<u>The</u> total <u>purchase</u> <u>price</u> was allocated by Gyro Engineering Corporation as follows." (Underscoring supplied). (R. I-51, 53, 54).

There is nothing "purported" about the purchase price in the

stipulation of facts.

(7) "No evidence was introduced to show that the taxpayer was held out to third parties as the owner of the land or apartment buildings after the transfer and through the years in suit." (Appellee's Brief at 6). However, the President of Gyro testified that Gyro made all the payments on the mortgages assumed by Gyro on January I, 1959 on the apartments. (Tr. II-248, Tr. III-439). Therefore, Gyro certainly held out to the owner of the mortgages (Massachusetts Mutual and Travelers, third parties) that it was the owner of the apartments. Also, the Commissioner of Internal Revenue asserted deficiencies in income tax against Gyro based on income derived from said apartments as shown in federal income tax returns filed by Gyro. Thus, Gyro held out to the Commissioner (a third party) that it owned the apartments, and the Commissioner agreed with Gyro in this case that it did.

(8) "Monies 'paid' to the transferors as 'sellers' of the apartments were not withdrawn but were simply represented by funds already in their personal account, which account was also used by the taxpayer." (Appellee's Brief at 8). However, Stipulation of Facts No. Two states that:

> "Payment of principal were to be made at the rate of $60,000.00 per year. ... The said $60,000 annual payments were made through 1963 or a total of $300,000.00."
> (R. I-87).

Thus, the annual payments on the purchase price were paid.

(9) "At least some of the checks in evidence were clearly for personal expenses of the Mowrys." (Appellee's Brief at 9). If so, how could the District Court have allowed, as it did, the total of such expenses and checks as proper deductions from Gyro's gross income? The government's statement actually contradicts the trial court's ruling.

(IO) Chris Mowry testified, with reservation, that he would be agreeable to "subordination". (Appellee's Brief at IO). Actually Chris Mowry testified that there was about $2,000,000 still due to him and Natalie Mowry on the $3,I64,000 sale price, and that Gyro had recently obtained mortgage loan commitments on the apartments of $I,800,000, after which the trial judge asked if in his negotiations on such loan commitments he and Natalie Mowry would be required to subordinate their $2,000,000 indebtedness and whether this would be agreeable to him. (Tr. III-344-345). The full answer was:

> "Provided that we got paid the proceeds of the loan. Otherwise, no." (Tr. III-345).

That is, the government's phrase "with reservation" actually means that Chris Mowry testified that he would not subordinate the $2,000,000 indebtedness to him unless he and Natalie Mowry received $I,800,000. (Tr. III-345-346).

(II) "The ratio of debt to equity at the time of the transfer was 3I6.4 to I." (Appellee's Brief at IO). However, since Gyro knew in I958, prior to the January I, I958 acquisition of the apartments, that it was going to receive a net of $30,000 from the condemnation award on the Paloma

Street property (Tr. III-423-425), and had in addition a $I0,000 capital stock account, it had a capital structure of $I0,000 plus the $23,096.65 gain from the condemnation award or $33,096.65. The debt to equity rate was therefore $3,I64,000 to $33,096.65 or 90 to I rather than 3I6.4 to I.

(I2) In deficiency notices for the years involved, the Commissioner of Internal Revenue determined that Gyro must use Chris and Natalie Mowry's cost basis in the apartments "on the ground that in substance and for federal income tax purposes, the transfer was not a bona fide sale, but rather was a contribution to taxpayer's capital." (Appellee's Brief at I2). Actually, the author of the deficiency notices, Mr. John W. Nisbet, stated categorically that "the statutory notices do not mention the theory of law" (Tr. II-I68-I69), and that any written reference to the basis of the deficiency was in an office statement which is never shown to or mailed to taxpayers and was not presented to Gyro. (Tr. II-2II, 2I6). All the court needs to do to satisfy itself that this statement of "fact" by the government is as false as the others reviewed above is to read the deficiency notice which is totally devoid of any ground in support of the deficiencies asserted. (R. I-I7-2I).

(I3) The District Court "found" that "the recited 'price' for the transferred buildings was excessive in relation to their fair market value." (Appellee's Brief at I2). The fact is that the District Court made no such finding, and if it had, it would have been clearly erroneous. The subject finding

of fact (No. 47) stated that:

> "Both plaintiff and defendant presented expert evidence on the fair market value of the properties at the time of the transfer. While this evidence is <u>in part</u> conflicting, after careful consideration the Court is <u>inclined</u> to the view that the recited 'price' was <u>somewhat</u> excessive in relation to fair market value." (R. II-726).

This does not find as fact that the price was excessive as the government states. It simply finds that the trial court is "inclined to the view" that the price was "somewhat" excessive. How much is somewhat? One dollar? And for the reasons set forth at pages 40 and 41 of Gyro's opening brief here, if such a finding had been made, it would be clearly erroneous.

ARGUMENT

Before responding to the specific contentions found in the government's brief, there are certain general infirmities to its arguments which render them of no merit.

First, it is necessary to note that Gyro's opening brief asks reversal on the grounds that: (I) at least 35 of the findings of fact, upon which crucial conclusions of law were based, are clearly erroneous; (2) certain findings of fact, which are prerequisite to some of the critical conclusions of law, were never made; and (3) many of the controlling conclusions of law misinterpret and misapply the applicable law. To

(I) and (2) above the government has responded with silence or a citation to the challenged finding itself as "authority" followed by a trial de novo type argument in which the same arguments made to the trial court have simply been reiterated here. Thus, nearly two-thirds of the government's brief is a statement, restatement, and reiteration of its restatement, of its version of the "relevant" facts. To (3) above, it set forth its version of the law.

Second, the case the government is arguing on appeal here is neither the case which was decided by the trial court nor the one appealed to this court. Thus, the trial court's ruling below, after the filing of briefs, was that:

> "The transfer from the Mowrys to Gyro of the apartment houses was a sham, without substance, and therefore for income tax purposes was merely a contribution to the capital of Gyro." (R. 643)

That is, the trial court ruled the transfer was a sham. However, here the government, for obvious reasons, does not want to defend that ruling, and is attempting to defend the different proposition that "the purported sale in substance constituted a contribution to taxpayer's capital."[I] In short, the government is trying to convert this appeal into a "substance over form" case whereas the trial court actually found that the transfer was a sham and "therefore" a contribution to capital. Why

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[I] See page I8 of Appellee's Brief.

does the government do this? Because if the transfer was a sham, which the trial court ruled it was, there was no transfer for federal tax purposes, and the income from the apartments must remain the income of Chris and Natalie Mowry rather than income of Gyro's. To try and avoid this error, the government now pretends that the trial court did not rule that the transfer was a sham and therefore a contribution to capital. It does not wish to explain how a transfer could be a sham and yet still be a transfer resulting in a capital contribution.

Third, the government has made no attempt to answer Points V, VI, VII, XI, and XII of Gyro's opening brief.

Fourth, under the very criteria cited by it, the government cannot prevail because the findings of fact in support of the application thereof are clearly erroneous.

A.

The Government Has Failed To Respond To The Contentions Made By Gyro

As shown below the government has not responded to the contentions made by Gyro in its opening brief.

I.

Gyro's first contention, at pages 13 through 23, was that Commissioner v. Brown, 380 U. S. 563, 578-579 (1965), held that when Congress has considered the practice of selling depreciable assets to controlled corporations, and has responded with the precise provision of narrow application set forth in Section 1239 which did not deny the fact or occurrence of a

sale, the Commissioner cannot, via the strategem of contending there was no sale, invade the policy of Congress and therefore fashion a broader rule. The government's complete "answer" to such argument is set forth in footnote 4 at page 18 of its brief wherein it states that to assume there was a sale here "is to beg the very point at issue" which it says is whether there was a sale. In short, the government has begged the very issue raised by Gyro by claiming that Gyro has begged the issue here.

The point which the government has decided not to answer is that Commissioner v. Brown, supra, held that the word "sale", as used in the Internal Revenue Code, unlike the creatures of tax law known as "capital gain" and "capital asset", is to be given its common and ordinary meaning by the courts, and where the Congress has dealt with a specific problem and responded with a provision of precise application (1239), which does not deny the fact of a sale, then the Commissioner is not empowered to broaden that rule by challenging the existence of a "sale" by giving the word a special interpretation for federal tax purposes. That the government has done precisely that is shown by its repeated arguments to the District Court that the issue here is whether this was "a sale within the terms of The Internal Revenue Code - not whether this is a sale otherwise." (Tr. V-715).

2.

Point II of Gyro's opening brief, at pages 23 through 29, was the government stipulated that Gyro purchased the apartments,

and it was clearly erroneous of the trial court to find that it did not. The government's entire "answer" thereto is set forth in footnote 5 at page 19 of its brief. There is found the self-serving conclusion that the word purchase was employed "to indicate only what the parties purported to do." But where is the language in the stipulation or the pretrial order so limiting the stipulation, and what would be the point of such a stipulation? Also, the government tenders the thought that if the word purchase in the stipulation is to be distorted and stretched to mean just what it says - purchased -, then that would be to attribute to the government a concession of the issue of whether there was a sale. That is, the government is saying that the Court cannot apply the words used in a stipulation if the effect is to cause the government to lose. This is an interesting notion, but hardly a tenable one. Furthermore, it is grossly misleading for the government to suggest that it could not have intended, assuming its post trial intention is relevant, to stipulate there had been a sale. Why? The reason is that the government's sudden discovery of the "sale" issue did not occur until long after it had signed the said stipulation. What happened was the following.

The 30-Day letter issued to Gyro for the years involved asserted a deficiency of only $5,774.16, and adopted a theory allocating all of Gyro's income and expenses to Chris and Natalie Mowry. (R. 1-9, 12). Thereafter, Mr. John W. Nisbet, a Texas public accountant employed by the Appellate Division of the Internal Revenue Service, devoted 91 hours to the reading

of every tax case he could find and generally doing research on the case and the law after which he wrote the statutory deficiency notice to Gyro for about $100,000 which notice he conceded contains no explanation whatever of the government's theory or position. (Tr. II-161, 201-202, 169-172). Later on October 15, 1965, after the complaint herein was filed, Mr. Nisbet's deposition was taken and he was asked by plaintiff if the disallowance was based on the theory that the transfer to Gyro was a nontaxable exchange (Section 351) ? Upon instruction from the government's trial counsel below, Mr. Nisbet then answered: "Yes, nontaxable exchange." (R. I-134).

It was after Mr. Nisbet had testified at his deposition that the transfer was a nontaxable exchange that the government's trial counsel then stipulated in Stipulation of Facts No. I that Gyro purchased the apartments. Said counsel filed the said stipulation on May 11, 1966. (R. I-46). At that point the government's "sleeping dog" (there was no sale but a contribution to capital under Section 362 (a) (2)) had never been mentioned to Gyro's counsel by the government's trial counsel, nor had any written notice, formal or informal, ever been issued to Gyro stating that it was not claiming there had been a nontaxable exchange under Section 351 but instead or in the alternative that there had been no sale but a contribution to capital under Section 362(a) (2). Therefore, for the government to state or imply that the word purchase in the May 11, 1966 stipulation should not be given the meaning purchase because the government would then be deemed as having

stipulated away its case on May 11, 1966 is grossly misleading.

3.

The government made no response to Gyro's point that since the government stipulated that Gyro purchased the apartments, the trial court erred in finding that Gyro purchased the apartments (Finding of Fact No. 2) and then concluded that it did not.

4.

Gyro's fourth point was that Commissioner v. Brown, 380 U. S. 563(1965) defined the word "sale" as used in the Internal Revenue Code to be simply a "transfer of property for a fixed price in money or its equivalent," and that the record and the government's own concessions show that such a transfer occurred here. Thus, the trial court erred in ruling there was no sale. The government's full "answer" therero is in one sentence of page 31 of its brief and footnote 13 at said page.

Its answer is that Brown presented a different issue, and that the facts there were different. However, as emphasized at pages 30 and 33 through 36 of Gyro's opening brief, assuming arguendo there was a valid distinction on the facts, the Supreme Court's definition of the word "sale" as used in the Internal Revenue Code cannot be dismissed. The case was not an ad hoc decision, but was taken by the Supreme Court because the Commissioner told it that it was one of the most important tax cases ever to come to the Supreme Court, and that the latter should tell the lower courts what the word "sale" means because there was no core of agreement in the lower courts.

The Supreme Court then gave its definition which the Commissioner obviously does not like, and hopes to avoid by telling the lower federal courts that Commissioner v. Brown is limited to its facts - a patently erroneous statement.

5.

Gyro's fifth point was that both the Commissioner and the Supreme Court in Commissioner v. Brown, supra, recognized that once the Commissioner concedes there was a sale under local sale, as he did here, he has of necessity abandoned his argument that the transaction was sham. The government failed to respond to this point.

6.

The sixth point advanced by Gyro was that the trial court erred in ruling that the transfer from the Mowrys was a sham, and then ruling that there was a transfer which was a contribution to Gyro's capital. Again the government has been unable to answer the contention, and has instead stated, at page 18 of its brief, that the sale "in substance constituted a contribution to taxpayer's capital." But that is not what the trial court's basic ruling of March 22, 1967 said. It ruled that "the transfer from the Mowrys to Gyro of the apartment houses was a sham, without substance, and therefore for income tax purposes was merely a contribution to the capital of Gyro." (R. II-634). What the government has done is misstate the first part of the trial court's ruling, and then focus the attention on only the second half thereof. There are two sides to the coin. The one is that the transfer did not occur (transfer

a sham, without substance), and the other is that "therefore" there was a contribution to capital. And it is the second side that is a non-sequitor. It cannot follow from the ruling that there was no transfer (transfer a sham) that "therefore" there was a transfer which resulted in a contribution to Gyro's capital. And that is why the government is pretending that the trial court did not rule that the transfer was a sham by urging that the question here is whether under the doctrine that substance governs over form the transfer was a sale or a contribution to capital. That is, after citing the trial court to numerous facts showing that Chris and Natalie Mowry were still the owners of the income from the apartments and then asking the trial court to conclude that the transfer was a sham, the government now wishes to pretent that that is not what the trial court did.

7.

Gyro's seventh point, and a vital one, is that the trial court made no finding that Chris and Natalie Mowry, the owners of 55% of Gyro's capital stock, intended to make a contribution to Gyro's capital of $2,372,361.50 which was their equity in the apartments. The government has submitted no answer at all to such contention.

8.

The eight point made by Gyro was that when the Commissioner departs from the grounds relied on in his notice of deficiency to sustain a theory later raised, he has the burden of proving any new matter raised, and hence, where as

here, he has not done so, the taxpayer prevails. The government's entire "answer" thereto is in footnote 7 at page 24 of its brief and at pages 23 and 24 in the text.

One half of the government's response, in footnote 7, is the patently erroneous statement that "the cases on which the taxpayer relies involved deficiency redetermination proceedings in the Tax Court, where the question is whether the Commissioner's deficiency notice is correct, and not refund suits in the District Court, where the taxpayer must prove that the Government owes him money." Since the only two cases cited by Gyro as authority for its contention are District Court cases (one from Arizona and the other from Nebraska), it is virtually inconceivable that the government would submit to the Court such a misstatement. In any event, its "distinction" is non-existant.

The other half of the government's attempt to by-pass the rule that it has the burden in a refund suit of proving any new matter raised when it departs from the grounds relied on in the Commissioner's deficiency notice is the statement that the taxpayer must prove not only that the Commissioner's determination was wrong, but also establish the exact amount of the tax allegedly overpaid. The implication or unspoken inference of this statement is that in order to establish the exact amount of tax, the taxpayer's burden includes overcoming every conceivable theory which the Commissioner may raise, before or after the trial, including those not set forth in the deficiency notice whether or not

the government has proved new matters which it raised after departing from its deficiency notice. In short, the government is saying that, after the deficiency notice was issued here, it could adopt the theories that: (I) the transfer was a sham, or (2) in substance there was not a sale but a contribution to capital, or (3) the transfer was a nontaxable exchange under Section 35I, or (4) the corporate income should be allocated to Chris and Natalie Mowry, or (5) Chris and Natalie Mowry were the same as Gyro and therefore Gyro paid none of the expense deductions claimed, and that the government has no burden whatsoever to prove the new matters raised because the taxpayer must show the exact amount of tax paid and he cannot do this until he has carried the burden of proving new matters respecting all of the government's theories. Surely to state the government's contention is to refute it.

9.

Gyro's ninth point was: the government's contention that there was no sale but a contribution to Gyro's capital is barred by the statute of limitations provided for in Section 650I (a). <u>Hammond</u> v. <u>Maloney</u>, 80 F. Supp. 2I2, 2I7 (D. C. Ore. I948), aff'd 9 Cir., I949, I76 F. 2d 780. This case is not novel. A rule that an amount refundable can not be applied against a tax which is not collectible, either by assessment or suit, due to the running of the statute of limitations, has been applied by the Commissioner since I92I. I-I CB 3I3. Nevertheless, the government contends that three cases sustain the proposition that the government may raise any new defense

at the trial even if the statute of limitations has run on making an additional assessment for that year.

The government's first case, Lewis v. Reynolds, 284 U. S. 28I(I932) was decided I7 years before this Court affirmed Hammond v. Maloney, 80 F. Supp. 2I2, 2I7, and therefore it must be concluded that this Court did not so interpret Lewis v. Reynolds, supra, since it certainly would not have affirmed a District Court decision contra to a decision of the Supreme Court of the United States. And since the other two cases cited by the government are decisions of the Eight Circuit (United States v. Pfister, 8 Cir., I953, 205 F. 2d 538 and Blansett v. United States, 8 Cir., I960, 283 F. 2d 474), there is no need to examine them in view of this Court's affirmance of Hammond v. Maloney, 9 Cir., I949, I76 F. 2d 780.

IO.

Gyro's tenth point was that there are 35 findings of fact upon which the conclusions of law rest which are clearly erroneous. The government has not answered these arguments. Instead it has recited its own version of the facts in which it misstates many crucial facts, omits facts bearing on critical findings, and cites the very findings of fact of the trial court which were challenged as clearly erroneous as its "authority" therefore.

II.

The eleventh point advanced by Gyro was that the trial court misinterpreted and misapplied the applicable law even if it were assumed that Commissioner v. Brown, supra, were

not applicable. The government's response and Gyro's reply thereto is set forth in Point I3 hereinafter.

I2.

As its twelfth point, Gyro pointed out that the only case cited by the government as interpreting Section 362 (a) (2) as it requested was Murphy Logging Co. v. United States, 239 F. Supp. 794, which was later reversed by this Court in 1967 at 387 F. 2d 222. The government has not replied to this point.

I3.

Gyro's last point was that there was a sale and purchase of the apartments, and therefore it did purchase property within the meaning of Section 1033. The government's answer is that there was no sale, and its response is erroneous for all of the reasons heretofore and hereinafter set forth by Gyro showing there was a purchase.

B.

Assuming Arguendo That The Definition Of Sale Set Forth In Commissioner v. Brown, 380 U.S. 563 (1965), Were Not Controlling, The Criteria Applied By The Trial Court Is The Result Of Misinterpretation Of The Law And Is Based On Clearly Erroneous Findings Of Fact.

In Point XI of its opening brief Gyro showed that assuming the definition of "sale" in Commissioner v. Brown,

supra, was not controlling, there was still not a single case cited by the government or the trial court which dealt with the specific issue raised by the government - was there a sale or a contribution _to capital_ within the meaning of Section 362(a)(2). It pointed out that the government's cases were concerned with whether there was a capital _investment_ (not the same as a contribution or donation to capital) or a sale, and that it had "extracted" those certain criteria from diverse cases involving different issues without applying all of the criteria set forth in each case.

The government's first "answer" is to say that "no one factor is conclusive." Gyro agrees but what of it? The unspoken inference is that since no one factor is controlling, the trial court is given license to select from diverse cases dealing with different issues or only half of the question presented (was there a sale or -) any criteria it chooses, ignore the others set forth in the case, and compile a list of criteria which determine nothing. Its second answer is to argue that the issue here is basically factual, and therefore any old criteria will do the trick no matter how obtained. However, if the issue is basically factual, then why the inordinate amount of legal "authority" in the findings submitted by the government. Also, if whether a transfer is in substance a sale is merely a fact issue, why did the government take that very same issue to the Supreme Court so that it could tell the lower court what criteria were to be applied in determining what was in substance a sale? Surely,

it is obvious that when the government, at this stage of the case, claims the issue of whether there was in substance a sale is a factual issue and therefore misapplying the case law criteria really does not matter, it is admitting that it mislead the trial court.

But the criteria it sets forth at page 20, dicta from O.H. Kruse Grain & Milling Co. v. Commissioner, 9 Cir., 1960, 279 F. 2d 123, is, on its face, not applicable. As the government states, the factors listed determine "whether amounts advanced to a corporation constitute equity capital (not a contribution or donation to capital) or indebtedness (not a sale)." For example, one of the factors mentioned is payment of interest out of dividends only, clearly inapplicable here.

Nevertheless, assuming arguendo that the eleven criteria set forth as dicta in O. H. Kruse Grain & Milling Co. v. Commissioner, supra, were not those used, as Judge Barnes said, in determining whether amounts advanced to a corporation constitute equity capital or indebtedness but those used to determine whether there had been a sale or a contribution to capital within the meaning of Section 362(a)(2), the findings of fact would be clearly erroneous if they did not support a conclusion that there had been a sale. Why? For the following reasons:

(1) Criterion No. (1) is entitled "the names given to the certificates evidencing the indebtedness." Here it was stipulated by the government that Gyro issued and delivered to Chris Mowry on January 1, 1959 three "promissory notes

dated January 1, 1959, one of which was in the face amount of $1,970,829.65, another in the face amount of $170,363.35 and the third in the face amount of $201,168.50." (R. I-50).

(2) Criterion No. (2) is designated "the presence or absence of a maturity date." Here the $1,970,829.65 promissory note calls for semi-annual payments of $20,000 each on June 1st and January 1st (R. I-73), while the other two notes call for $5,000 semi-annual payments on June 1st and January 1st (R. I-74, 75). Thus, and as the trial court found as fact, the notes had a maturity date of 39.03 years. (R. II-715, Finding of Fact No. 24).

(3) The third criterion is "the source of the payments." The government implies this is a ban against payments of the purchase price from income earned by the asset sold despite the express rejection thereof. Commissioner v. Brown, 380 U.S. 563, 570. However, O.H. Kruse, supra, must be read in the light of the more recent holding in Commissioner v. Brown, supra, and therefore "the source of the payments" must be interpreted to cover the case where seller is to receive his payments only out of profits as would be the case with a dividend. Here the fact is that $300,000 annual payments were made from 1959 through 1963 even though the returns for 1959 and 1960 show there was no profit. (R. I-87, 65, 70).

(4) The right to enforce the payment of principal and interest is the fourth criterion. Both the Sale and Purchase Agreement (Exhibit 4 to Stip. No. 1) and the Trust

Agreement incorporated by reference therein(Exhibit 10) allow sellers to foreclose upon default or operate the property.

(5) The fifth criterion is "participation in management." Here Chris Mowry participated in management, and this is the first criterion of the two referred to in O. H. Kruse, supra, which is presented here by the Commissioner.

(6) The sixth criterion is "a status equal to or inferior to that of regular corporate creditors." Here the terms of the trust agreement incorporated into the Sales and Purchase Agreement provide that upon default the sellers may declare all sums due and payable, the property may be seized, and then operated or sold, and in general foreclosure effected. (Exhibit 10). Also, the terms of the Sales and Purchase Agreement provide that the purchaser execute and deliver an assignment of rents and management on each property to secure the payment of each note if there is a default or the buyer becomes insolvent. (R. I-72). Thus, the sellers were neither equal to nor inferior to regular corporate creditors. And for the reasons set forth at page 62 and 63 of Gyro's opening brief, there was no subordination in fact.

(7) The seventh criterion is "the intent of the parties." Here Chris Mowry's testimony on intent was that neither he nor Natalie Mowry had any intention of making a gift or donation or contribution to capital of Gyro of their equity in the apartments sold. (Tr. III-335-336, 349-350).

(8) The eight criterion mentioned in O. H. Kruse, supra, is a "thin or adequate capitalization." Here the ratio

of debt to equity is 90 to 1 as shown at page 63 of Gyro's opening brief. Hence, if the Court deems this a "thin capitalization" and a relevant factor despite the rejection thereof by implication in Commissioner v. Brown, supra, (a purchase price of $1,300,000 and a capitalization of $25,000 or 52 to 1), this is the second of the two criterion applicable out of eleven.

(9) The ninth criterion listed was "identity of interest between creditor and stockholder." In O. H. Kruse, supra, the Court mentioned that 100% of the taxpayer's stock was owned by the creditor thereby reflecting identity of interest. But here Chris and Natalie Mowry owned only 55% of Gyro's stock, and hence there was no "identity" of interest.

(10) The tenth criterion mentioned in O. H. Kruse, supra, was "the payment of interest only out of 'dividend money'." Here the annual payments of $60,000 were made even though Gyro had no profit in 1959 and 1960. (R. I-65, 70).

(11) Finally, the eleventh criterion was "the ability of the corporation to obtain loans from outside lending institutions." Here, the record shows that Gyro obtained loan commitments of $1,800.000 on the purchased properties. (Tr. III-345).

Since only two of the eleven criteria referred to in O. H. Kruse, supra, apply here, what other criteria does the government seek to apply, regardless of its source, which is based on a clearly erroneous finding of fact?

One is the claim that Gyro was "essentially" moribund

and was revived by the purchase. (Appellee's Brief at 25). The evidence is contra since from 1953 to January 1, 1959, Gyro investigated the acquisition of several parcels of real estate, did work on long range weather forecasting, how the eye sees color, and the unified field theory, as a result of which Gyro now makes accurate long range weather forecasts and has a patent pending covering three dimensional color television. (Tr. II-239-240).

Another of the government's criteria is the statement that the seller failed to press for payment on the notes after default. (Appellee's Brief at 27). This is really a remarkable argument because it amounts to a contention that the validity of the government's assessments here should be sustained because Gyro paid the assessments made. Why? Because the returns in evidence (R. I-65, 70) show that Gyro's disposable cash, before claiming a depreciation deduction based on the January 1, 1959 sale price,was an average of about $118,000 annually. Out of that sum, Gyro paid the $60,000 annual purchase price payments and the mortgage principal payments due the insurance companies, the total of which consumed the $118,000. However, when the government claimed about $52,000 annually as tax and interest for 1959 and 1960 by disallowing the sale price as the basis for depreciation, Gyro was required to pay the 1964 annual purchase price installment of $60,000 as well as the 1965 annual purchase price installment of $60,000 to the government. Thus, in 1964 it paid about $104,000 for 1959 and 1960 taxes and interest

claimed and had to be prepared to pay an equal amount for 1961 and 1962 as well as for 1963 and 1964. After paying the principal on the first mortgage payments in 1964 and 1965 plus the claimed taxes, there was nothing left to pay the annual payments thereafter. Thus, the government says there was subordination because it was paid the taxes it claimed, and the validity thereof can be sustained because in point of fact it assessed and collected said taxes.

Also, the Court knows, if the government does not, that foreclosure by the Mowrys in 1964 would result in the acceleration of gain on their installment gain sale contract thereby causing over $2,000,000 of capital gain to be realized and $500,000 of tax to become due should the sale of 1959 be upheld. In addition, the government had taken an official position with Chris and Natalie Mowry that since there was a contribution to capital rather than a sale of the apartments, the $300,000 paid to them on the purchase price is in reality the distribution of a dividend on which they must pay ordinary income tax rates.

The government's next criterion states that "there was no security behind these notes." (Appellee's Brief at 27). However, both the Sales and Purchase Agreement and the trust agreement terms incorporated therein flatly contradict such a claim.

Next, the governemnt cites as a criterion that the audit of Gyro's returns "began early in 1961" after which it "obtained for the first time written appraisals for the fair

market value of the property" and "recorded the deed." (Appellee's Brief at 28-29). However, written appraisals were obtained in response to a request from a Revenue Agent, and it hardly seems equitable for the government to request such written appraisals and then claim that honoring that request constitutes an attempt "to dress up the transaction." (Tr. III-433). Also, the deed was recorded March 17, 1961, and therefore any implication that it was done after Chris Mowry received notice that the Commissioner was either auditing the 1959 and 1960 Gyro returns or claiming the transaction was a sham is wholly without support. In the first place, the 1959 Gyro return was only "assigned for audit by the Internal Revenue Service on January 27, 1961," and the 1960 Gyro return was not "assigned for audit until October 13, 1961." (R. I-92). The Revenue Agent who conducted the said audit testified that he wrote his report in 1962, and that his audit required three or four months. (Tr. II-138). Thus, since the Agent's audit was for both 1959 and 1960, it is clear that his audit was conducted in November and December of 1961 and in part of 1962, and it is clearly erroneous to state that Chris Mowry was dressing up the transaction after the audit began or was completed. The Revenue Agent's testimony conforms to Chris Mowry's testimony that the first time the I. R. S. talked with him was in the late Spring of 1961 (Tr. III-344).

Next, the governemnt states as a criterion that the transfer had little purpose other than to avoid taxes (Appellee's Brief at 29), and cites as its authority the very findings

of fact which Gyro has attacked in its brief as clearly erroneous.

More importantly, the government sets forth as another criterion that the taxpayer's own valuation expert, Mr. Vaughn, testified that the fair market value of the apartments was $2,427,750 or 30% less than the $3,164,000 January 1, 1959 sales price. Since a grossly excessive "sale price" is the factor which the Supreme Court relied on in Commissioner v. Brown, supra, to distinguish Kolkey v. Commissioner, 27 T.C. 37, aff'd 7 Cir. 1956, 254 F. 2d 51, the said inexcusable misstatement by the Commissioner, Gyro submits, is warrant for the conclusion that the governemnt has no case at all. Why? Because Mr. Vaughn never testified that the fair market value was $2,427,750 nor did the trial court so find. The court evaded this crucial issue by finding nothing when it said it was "inclined to the view that the recited 'price' was somewhat excessive in relation to fair market value." (R. II-726). Thus, the government has substituted its own "finding" for the one actually made by the trial court. And Mr. Vaughn testified explicitly that the fair market value of all the apartments on January 1, 1959 was $2,985,000 or $179,000 less than the $3,164,000 sale price, (Plaintiff's Ex. 1, Tr. I-77, 86, 91), clearly within a reasonable range of the fair market value especially since his $2,985,000 value was based on all cash being received by the sellers, (Tr. I-105-106). Commissioner v. Brown, supra. Mr. Vaughn testified very specifically that he "gave consideration" to the three conventional "approaches" to valuation, namely

the summation or cost approach, the comparable sales approach, and the capitalization of income approach, and stated that "I will not" arrive at an opinion as to the fair market value of the property until I consider all three approaches. (Tr. I-61, 71).

Furthermore, the government's own "expert" on valuation, an Internal Revenue Agent, testified that he himself would have bought the apartments for $3,164,000 with $30,000 down and annual payments of $60,000 per year. (Tr. IV-601-602, 605). And the devasting effect of such testimony by the government's "expert" was acknowledged by the trial court which refused to admit summary of his valuation into evidence as he had with respect to Mr. Vaughn's testimony, and later ordered the summary struck from the government's brief as an exhibit. (Tr. I-93, V-603, R. II-542-543, 632). Worse yet for the governemnt, the testimony of its "expert" was offered at the outset thereof for the following purpose:

> "The main thrust of Mr. Halstead's testimony will be to the question of whether or not an investor would make this - a normal investor, assuming normal motives - would make this kind of a purchase. In other words, was this an economic purchase or on the other hand was it, was we contend, a sham transaction." (Underscoring supplied). (Tr. IV-542).[2]

That is, his testimony as to whether an investor would make the instant purchase was to be the government's evidence that the transaction was a sham, and yet that "expert" testified he would "as a hypothetical average investor" certainly "purchase" the apartments for $3,164,000. (Tr. IV-604-605).

Furthermore, this case is not in this Court as a trial de novo for a finding of fact by a court of appeals as to what was the fair market value of the apartments. Findings of fact must be made by the trial court under Rule 52 after which the party affected has the opportunity to appeal on the ground that the finding of fact is clearly erroneous. The government is in effect asking the Court of Appeals to make a finding of fact - that the fair market value of the apartments was 30% less than $3,164,000 - which the trial court would not make, and then asking that a judgement which is not founded on that new finding be affirmed.

Another criterion advanced by the government was that the down payment was only $30,000 on a sales price of $3,164,000. (Appellee's Brief at 30). However, Commissioner v. Brown, supra at 570, rejected the view that a low down payemnt supports a conclusion that in substance there was no

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[2] It is significant to compare the above presentation of the sham transaction position to the trial court and its other statements to the trial court that its position was that the transfer was a sham (R. I-494, Tr. V-707, 709) with its abandonment in this Court of Appeals of such argument in footnote 12 at page 29 of its brief stating that "The government's position is not that the transfer was a sham" but that "the 'sale' label attached to the transaction by the parties is not determinative of its substance and tax effect."

sale.

Also, the government urges that a criterion is the fact that the transferors were not discharged from their obligations on the first mortgages. (Appellee's Brief at 30). Gyro's counsel cannot recall any instance in which an insurance company holding a mortgage has ever released the sellers upon a sale. If that is the test of a "sale", then there are very few sales of real estate in this country.

Next, the governemnt sets forth the criterion that "the transaction did not take place at arm's length, but was between a corporation and its controlling shareholders." (Appellee's Brief at 30). But if that is the test of an arm's length transaction, rather than whether the purchase price was within a reasonable range of the fair market value, then there can never be a "sale" of depreciable property under Section 1239 between shareholders owning over 50.1% of the stock and the corporation despite the provision in Section 1239 that capital gain will be denied only if the controlling shareholders own 80% or more of the stock. That this argument, that an arm's length transaction cannot exist when there is a transfer between shareholders owning 50.1% and their corporation is the key to the trial court's holding is seen by the following at the close of the trial:

> "Mr. Jones: Well, I think that if it were an arm's length transaction -
>
> The Court: That is the key to the whole thing, what is an arm's length transaction?

> Is it a transaction whose motivating purpose is the avoidance of taxes? You say that cannot be an arm's length transaction?
>
> Mr. Jones: ... here you don't have an arm's length transaction ...
>
> Here you have a corporation which is controlled and dominated by the transferor of the property. And the courts have distinguished the Brown case on that basis." (Tr. V-706-707).
>
> ...
>
> When a controlling stockholder deals with his corporation it seems to me there is almost a presumption - an inference arises immediately that you don't have what is called an arm's length transaction."
>
> ...
>
> I would say that the only point of such an inference is that it shows again control and domination by the seller and suggests a sham transaction." (Tr. V-709).

The foregoing are some of the reasons why the criteria applied by the governemnt and/or the trial court are based on clearly erroneous findings of fact and misinterpretations of the law.

C.

Having Now Abandoned In Its Brief The Contention That The Transfer Was A Sham And Arguing Instead That It Was Not In Substance A Sale, The Holding Of Commissioner v. Brown, 380 U. S. 563 (1965) Is Controlling Here And Requires Reversal

The full circle has been completed by the government. Just as it finally did in this Court in Commissioner v. Brown, 9 Cir., 1965, 325 F. 2d 313, the government now concedes in footnote 12 at page 29 of its brief that it has abandoned the argument that this transaction was a sham. The footnote states:

> "The Government's position is not that the transfer was a sham,... but that the 'sale' label attached to the transaction by the parties is not determinative of its substance and tax effect."

In short, the government is now making the same argument here which the Supreme Court said it made in Commissioner v. Brown, 380 U. S. 563 (1965).

> "Having abandoned in the Court of Appeals the argument that this transaction was a sham, the Commissioner now admits that there was real substance in what occured between

> the Institute and the Brown family. The transaction was a sale under local law."
> 380 U. S. 569
>
> "Whatever substance the transaction might have had, however, the Commissioner claims that it did not have the substance of a sale within the meaning of § 1222(3)."
> (Underscoring supplied) 380 U. S. 570

Therefore, since in Commissioner v. Brown, supra, the Supreme Court was asked to, and did, give a definition of what "sale" meant as used in the Internal Revenue Code, the applicability of that decision to the instant case is clear.

In Commissioner v. Brown, supra, the Supreme Court ruled that the word "sale" as used in the Internal Revenue Code is to be given its ordinary meaning, and that therefore a "sale" is simply a transfer of property for a fixed price in money or its equivalent. Therefore, here there was a sale.

What the trial court and the government have done herein is refuse to follow the ratio decidendi of Commissioner v. Brown, supra. The trial court should be reversed for so doing.

CONCLUSION

The judgment below should be reversed.

Respectfully submitted,

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Certificate

I certify that, in connection with preparation of this brief, I have examined Rules 18, 19, and 39 of the United States Court of Appeals for the Ninth Circut, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William Lee McLane

Dated: August 7, 1968

William Lee McLane